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Why do Reits chase scale?

The average size of S-Reits was slightly below S$1 billion before 2010, it then increased to around S$1.4 billion before 2018. BY CHEW TUAN CHIONG AND SING TIEN FOO

"BIGGER is better" has been an underlying factor driving the consolidation of the US real estate investment trust (Reit) market in the 1990s.

Large Reits outpaced the growth of smaller Reits through mergers and acquisitions (M&A). Reits grow assets under management (AUM) by either acquiring new real estate or taking over wholesale real estate portfolios from acquired Reits.

Since the first Reit emerged in Singapore 20 years ago, the Singapore Reit (S-Reit) market has grown exponentially by 155 times from S$734 million in 2002 to S$113.56 billion, equivalent to a compounded annual growth rate (CAGR) of 28.67 per cent. The strong growth momentum of S-Reits, especially in recent years, was driven by a slew of M&As.

S-Reits have become bigger over the years. The average size of S-Reits was slightly below S$1 billion before 2010 and then increased to approximately S$1.4 billion before 2018.

There have been 7 consolidations after 2018, significantly driving up the average size of a S-Reit to around S$2 billion.

In 2020, CapitaLand Mall Trust (CMT) and CapitaLand Commercial Trust (CCT) were merged to form the largest S-Reit - CapitaLand Integrated Commercial Trust (CICT). The merged Reit has a market capitalisation of S$14 billion as of 2022.

The merger of Mapletree Commercial Trust (MCT) and Mapletree North Asia Commercial Trust (MNACT) was approved at the extraordinary general meetings (EGM) on May 23, 2022. It will lead to the creation of Mapletree Pan Asia Commercial Trust (MPACT), which is the third-largest S-Reit by market capitalisation after the CICT and Ascendas Reit.

S-Reit consolidations

Why do S-Reits follow the US trend in the 1990s of scaling up?

Many Reits chase scale to reap efficiency gains in operations and access to diverse sources of capital at competitive rates. They add value to unitholders through 2 channels, first by generating higher cash flows, and second, by lowering discounting factor (or the capitalisation rate as known in the private real estate market).

Higher cash flows can be achieved by increasing rental revenues and lowering operating costs through efficiency gains in physical real estate operations and management. A lower discounting factor is attained by optimising capital structure and cost of funds, reducing the weighted average cost of capital (WACC) for S-Reits.

Reits that meet certain size and trading thresholds enjoy inclusion onto major indices, which leads to increase in institutional following, and corresponding unit price boost. In equity fundraising (EFR), a higher unit price equates to a lower cost of equity, allowing the Reit to acquire higher quality assets. Thus, a virtuous cycle of expansion can be maintained.

Large Reits enjoy ample economies of scale. Reits could command market power in leasing out their real estate space with large real estate portfolios. For example, a retail Reit owning many shopping malls in town can attract international chained stores to take up anchor space in all the malls. It also has more bargaining power to negotiate favourable leasing terms from these anchor tenants.

On the cost side, large Reits can better reap scale advantages in rationalising processes and manpower to attain savings in operation costs. For example, a big retail mall Reit can negotiate and procure utility contracts below market rates with energy companies. They could also reduce costs by pooling resources from different malls when running advertising and promotional campaigns.

Bigger Reits are more competitive in capital management and are better positioned to take advantage of debt and equity funding for further growth. Banks are more willing to establish long-term banking relationships and extend favourable loan terms to large Reits, deemed preferred clients.

Larger Reits are more liquid in terms of free-float units and trading volume in the stock (public) market, which attract liquidity premiums, especially from institutional investors.

Reits should be mindful of unitholders' interests while chasing scale. Do M&As truly create value for them? How can the interests of investors be balanced against those of sponsors and Reit managers to achieve a good outcome? PHOTO: ST FILE

Reits with ample capital reserves can better weather economic and policy headwinds than smaller Reits. With the backing from strong sponsors, Reits could access financing and refinancing facilities, especially during a difficult time.

Amid the Global Financial Crisis in 2008, Fraser and Neave Limited (F&N) acquired a substantial stake in Allco Commercial Reit and a 100 per cent stake in the Reit manager, Allco (Singapore) Limited. F&N, the sponsor, renamed the Reit to Fraser Commercial Trust (FCOT) and helped recapitalise FCOT with the much-needed loan facilities of approximately S$650 million in 2009. FCOT has merged with another Frasers Reit to form Frasers Logistics and Commercial Trust in April 2020.

Are there monies on the table?

Reits should be mindful of unitholders' interests while chasing scale. Do M&As truly create value for them? How can the interests of investors be balanced against those of sponsors and Reit managers to achieve a good outcome?

Many factors may trigger an M&A. Financial distress is one possible factor that could "push" a Reit to find a potential buyer to take over their financial debt. Potential buyers could also be attracted to a target Reit that owns significantly undervalued assets.

M&A is an expensive exercise that may incur professional fees and expenses of between S$15 million and S$35 million. Some asset managers charge acquisition fees between S$8 million and S$15 million in M&A exercises.

The CMT manager waived the acquisition fee of S$111.2 million in the CICT M&A because of the unprecedented circumstances caused by Covid.

Who gains and who loses in an M&A? Past studies in the US have shown that unitholders of target (acquired) Reits enjoy significant positive gains from M&A announcements.

Unitholders of acquiring Reits will also expect managers and sponsors to create value before voting for taking over real estate portfolios of a target Reit. Many institutional investors have strong preferences for purity in asset class or geography, and would eschew blunt expansion without due consideration for synergy.

Acquiring Reits could reap scale economics via M&As. Reit managers usually take over not just a new portfolio of real estate, but in most instances, they will also absorb staff from the target Reits. Therefore, acquiring Reit managers need time to integrate and improve the performance of their enlarged portfolios on the premise that "1 plus 1 is more than 2".

Four of the recent M&As in the S-Reit market involved the merger of Reits controlled by the same sponsors. These Reit M&As pay mostly cash and scrip (units) as consideration in exchange for unitholders' interests in target Reits. Unitholders receiving the merged units as consideration could be worst off if the post-merger prices of Reit units decline.

In the recent MCT and MNACT M&A, the sponsor subsequently offered a cash-only option for MNACT unitholders when the MCT units declined below their notional value in the original offer. Effectively, the sponsor ensured that MNACT unitholders received the promised value. Over time, such investor-friendly acts are essential for S-Reits and the Reit sector to grow and thrive.

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